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In the Supreme Court of the United States

OCTOBER TERM, 1937

No. 563

UNITED STATES OF AMERICA, PETITIONER

v.

L. MANUEL HENDLER, AS TRANSFEREE OF CREAMERIES, INC. (FORMERLY HENDLER CREAMERY CO., INC.)

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE UNITED STATES

OPINIONS BELOW

The opinion of the District Court (R. 169–189) is reported in 17 F. Supp. 558. The opinion of the Circuit Court of Appeals (R. 200–204) is reported in 91 F. (2d) 680.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered August 7, 1937. (R. 200.) The petition for a writ of certiorari was filed November 6, 1937, and was granted January 17, 1938. The juris-

diction of this Court is conferred by Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether income realized in a statutory reorganization by the transferor corporation as a result of the assumption and discharge of its bonded indebtedness by the transferee corporation is exempt from taxation under Section 112 (d) of the Revenue Act of 1928 as "other property or money" received which the transferor corporation "distributes" in pursuance of the plan of reorganization.

STATUTE INVOLVED

The statute involved will be found in the Appendix, *infra,* pp. 17–19.

STATEMENT

The facts as stipulated (R. 31–150) and as found in the opinion of the District Court (R. 169–189) are as follows:

On June 21, 1929, Hendler Creamery Company, Inc., a Maryland corporation, transferred all its assets to The Borden Company, a New Jersey corporation. (R. 151–155, 170.) In exchange for those assets, Borden, pursuant to an agreement dated May 21, 1929, gave to Hendler 105,306[1]

[1] The stipulation (R. 32) declares the number to be 105,306, whereas the District Court's opinion fixes it at 106,306 (R. 170). Nothing, however, is made to turn upon this discrepancy.

shares of Borden stock (there being 3,256,993 shares outstanding) and $43,421.87 in cash, all of which Hendler immediately distributed to its stockholders. (R. 32, 35–36, 170.) In addition, Borden "assumed and agreed to pay" all the indebtedness and liabilities of Hendler, subject to certain exceptions not material here. (R. 9, 170.) Shortly thereafter, on June 25, 1929, Hendler changed its name to "Creameries, Incorporated" (R. 32), and was dissolved on August 5, 1930 (R. 35).

As a result of these transactions Hendler realized a profit of $6,608,713.65 (R. 172), most of which the Government did not seek to tax by reason of the reorganization provisions of the revenue law. The Government did, however, insist that of that profit, $534,297.40 was taxable, since that amount represented the expenditure by Borden to discharge Hendler's bonded indebtedness and was not relieved of tax by the reorganization provisions. The facts with respect to that item, in greater detail, are as follows:

On May 15, 1929, Hendler had an outstanding bonded indebtedness in the aggregate face amount of $501,000. (R. 21.) The bonds were subject to redemption on any interest payment date (interest being payable on January 1 and July 1 of each year) on 30 days' notice at 107½% of their principal amount plus accrued interest. (R. 4–5.) On May 15, 1929, the board of directors of Hendler voted to call and redeem all the outstanding bonds

(R. 66–68), and on the same day notice of redemption was sent to the trustee under the bond indenture (R. 73). Thus the steps necessary to redeem the bonds were started nearly a week before the operative agreement of May 21, 1929, and more than a month before the transfer of assets on June 21, 1929.

After the transfer of assets to Borden, and pursuant to the agreement of May 21, 1929, Borden, on June 27, 1929, undertook to discharge Hendler's obligation on the $501,000 outstanding bonds. Up to June 27, 1929, Borden had acquired $156,000 of those bonds, and in a letter of that date, it instructed the trustee to cancel those bonds on July 1, 1929, without payment. (R. 86.) In the same letter it instructed the trustee to redeem the remaining $345,000 bonds on July 1, 1929, and stated that for that purpose it had deposited with the Guaranty Trust Company of New York the sum of $381,225[2] to the credit of the trustee. In all, Borden effected the discharge of Hendler liabilities by expenditure of $534,297.40 with respect to the bonded indebtedness.[3] (R. 87, 170.)

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[2] Of that amount $345,000 was to be allocated to the face amount of the bonds, $25,875 to cover the premium of $7.50 per $100 bond, and $10,350 to cover accrued interest to July 1, 1929. (R. 86, 157.)

[3] As of the date of the transfer of assets to Borden (June 21, 1929), other outstanding liabilities of Hendler which were "assumed" by Borden were current bank loans ($1,050,000) and merchandise accounts ($130,410.78). (R. 170.) These items, however, are not involved in this controversy.

In its return for 1929 Hendler did not include as taxable income this amount of $534,297.40, representing the discharge of liabilities, nor any other part of the $6,608,713.65 profit realized on the exchange with Borden. The Commissioner did not object as to the bulk of the profit on the exchange, but took the position that the reorganization provisions did not exempt the item of $534,297.40. He made a deficiency assessment which was paid by L. Manuel Hendler, as transferee, on April 15, 1933, in the amount of $58,772.72, plus interest in the amount of $10,781.97. (R. 171–172.)

The present suit was filed July 11, 1934, to recover those amounts after a claim for refund had been denied. (R. 2.) The District Court held that the discharge of the taxpayer's bonded indebtedness was not taxable, and ordered a refund, after permitting an offset in the amount of $6,260.33, arising out of a different issue (R. 188–189), which is not now involved. The Circuit Court of Appeals affirmed.

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred:

1. In holding exempt under Section 112 of the Revenue Act of 1928 the income realized by Hendler Creamery Company as a result of the assumption and discharge by The Borden Company of the Hendler bonded indebtedness.

2. In affirming the decision of the District Court.

SUMMARY OF ARGUMENT

A

The exchange between Hendler and Borden resulted in realized profit of $6,608,713.65, which would normally be subject to tax under Sections 13, 21, and 22 of the Revenue Act of 1928 were it not for the reorganization provisions in Section 112. That profit includes $534,297.40, which represents the assumption and discharge by Borden of Hendler's bonded indebtedness. It is our position that while Section 112 relieves most of the $6,608,713.65 of tax, the item of $534,297.40 is nowhere exempted.

The provisions which respondent contends are effective to exempt the $534,297.40 are contained in subsection (d) of Section 112. Those provisions offer an exemption where the transferor corporation receives, in addition to stock or securities of the transferee, "other property or money" which it "distributes" in pursuance of the plan of reorganization.

The recent decision of this Court in *Minnesota Tea Co.* v. *Helvering*, No. 106, present Term, is, we submit, controlling here. That case held, *inter alia*, that the "distribution" necessary to come within the exemption clause must be a distribution to stockholders. Plainly, there was no such distribution of the $534,297.40 income in this case. Even if Hendler had received this amount in cash

from Borden and had then paid its bondholders, it is clear from the *Minnesota Tea Co.* decision that this item would not be exempt. The same result follows *a fortiori* here, where Hendler merely instructed Borden in advance to apply that amount directly to the payment of Hendler's bonded indebtedness. Indeed, the very nature of this income—the discharge of the taxpayer's obligations—renders it incapable of distribution at all. A contrary conclusion in the present case would operate to give Hendler a permanent exemption from taxation of this income rather than a mere postponement of tax, which is all that the reorganization provisions were intended to accomplish.

B

The District Court held that the item of income involved herein was not "other property or money" within the meaning of subsection (d) of Section 112, and from that holding it concluded that this item was exempt. The Circuit Court of Appeals, without specifically so stating, appeared to adopt the same chain of reasoning. We may assume, *arguendo,* the correctness of the preliminary holding that this item of income was not "other property or money" within the meaning of subsection (d). But an exemption does not follow from that determination. That determination would merely mean that, as this item is neither "stock or securities" nor "other property or money," it is not dealt

with at all in subsection (d), that the exemption granted by subsection (d) does not here apply, and that subsection (d) has no operative effect whatever with respect to this controversy. The result would be that this item of income would have to be treated as though Section 112 were entirely absent from the law—i. e., the item would simply remain to be dealt with under Sections 13, 21, and 22, which plainly impose the challenged tax.

ARGUMENT

THE ASSUMPTION AND DISCHARGE OF HENDLER'S BONDED INDEBTEDNESS BY BORDEN CONSTITUTED INCOME TO HENDLER, AND THERE IS NO PROVISION IN THE STATUTE THAT EXEMPTS THAT INCOME FROM TAXATION

A

As a result of the exchange between the Hendler and Borden companies, Hendler realized profit of $6,608,713.65. In particular, that figure includes the amount of $534,297.40, which represents the assumption and discharge by Borden of Hendler's bonded indebtedness. That amount was properly included in computing the profit, since it is clear that the payment of an obligation by another may be income to the one whose debt is discharged. *Douglas* v. *Willcuts*, 296 U. S. 1, 9; *Old Colony Tr. Co.* v. *Commissioner*, 279 U. S. 716; *United States* v. *Boston & M. R. Co.*, 279 U. S. 732.[4]

[4] Compare the administrative rulings of long standing to the effect that the assumption of a mortgage by a purchaser is the equivalent of money which the seller must include in

Accordingly, if the reorganization provisions (Section 112) were absent from the law, the *entire* profit of $6,608,713.65, including the item of $534,297.40, would be subject to tax under the usual provisions of the statute taxing net income (Sections 13, 21, and 22).[5] This apparently was not disputed by the court below, and the only question is whether Section 112 *exempts* income otherwise taxable under the basic provisions in Sections 13, 21, and 22.

There was, of course, a "reorganization" within the meaning of Section 112 i (1) (A), since there was an "acquisition by one corporation [Borden] of * * * substantially all the properties of another corporation [Hendler] * * *."[6] But Section 112 i (1) merely *defines* reorganization.

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the purchase price when computing gain. G. C. M. 2641, VI–2 Cumulative Bulletin 16; G. C. M. 4935, VII–2 Cumulative Bulletin 112.

See also *Gold & Stock Telegraph Co.* v. *Commissioner*, 83 F. (2d) 465 (C. C. A. 2d), certiorari denied, 299 U. S. 564; *Ossorio* v. *United States*, 18 F. Supp. 959 (C. Cls.), certiorari denied, October 11, 1937, No. 223, present Term; *Houston Belt & Terminal Ry. Co.* v. *United States*, 250 Fed. 1 (C. C. A. 5th); *United States* v. *Mahoning Coal R. R. Co.*, 51 F. (2d) 208 (C. C. A. 6th), certiorari denied, 285 U. S. 559.

[5] Cf. *United States* v. *Phellis*, 257 U. S. 156; *Rockefeller* v. *United States*, 257 U. S. 176; *Cullinan* v. *Walker*, 262 U. S. 134; *Marr* v. *United States*, 268 U. S. 536.

[6] See *Helvering* v. *Minnesota Tea Co.*, 296 U. S. 378, and related cases decided therewith.

The exemption from taxation must be found in the *operative* provisions of Section 112, and unless those operative provisions render the disputed income non-recognizable it must be taxed under Sections 13, 21, and 22 in the usual manner.

The only provisions in Section 112 that can possibly be invoked to grant the desired exemption are subsections (b) (4) and (d), *infra*, p. 18.

Subsection (b) (4) allows non-recognition of realized income only where the assets are exchanged "*solely* for stock or securities." [Italics supplied.] Since Borden's consideration for Hendler's assets included not only the assumption of the Hendler debts but also the payment of $43,421.87 in cash to Hendler, it is clear that subsection (b) (4) can have no application.

The remaining provision, subsection (d), permits non-recognition in the following terms:

> If an exchange would be within the provisions of subsection (b) (4) of this section if it were not for the fact that the property received in exchange consists not only of stock or securities permitted by such paragraph to be received without the recognition of gain, but also of other property or money, then—
>
> (1) If the corporation receiving such other property or money distributes it in pursuance of the plan of reorganization, no gain to the corporation shall be recognized from the exchange, but

> (2) If the corporation receiving such other property or money does not distribute it in pursuance of the plan of reorganization, the gain, if any, to the corporation shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property so received, which is not so distributed.

Under this subsection, the great bulk of the $6,608,713.65 profit was exempted. We contend, however, that the item of $534,297.40 is not relieved of tax by subsection (d), and that this case is ruled by *Minnesota Tea Co.* v. *Helvering,* No. 106, present Term, decided January 17, 1938.

There, this Court held that the "distribution" contemplated in subsection (d) is "a distribution to stockholders, and not payment to creditors." Accordingly, it concluded that the circuitous payment by a corporation to creditors by furnishing money for that purpose to its stockholders was not a distribution within the meaning of the exemption provisions.

The instant case follows *a fortiori* from that decision. In that case there was at least an actual transfer of funds to stockholders. Here there was not even the form of a distribution to stockholders. Borden in the first instance effected a discharge of Hendler's bonded indebtedness. If Borden had, instead, given the money directly to Hendler, and if Hendler itself had then paid the bondholders, it is plain that this income would not have been

exempt under subsection (d). *Minnesota Tea Co. v. Helvering, supra.* In neither situation could it be even remotely contended that there is a distribution to stockholders. Indeed, since the $534,297.40 income herein arises, not from the actual receipt of cash by Hendler, but rather from the assumption and discharge of the indebtedness (sometimes referred to as constructive receipt), it is difficult to see how there could be any "distribution" of that income to anyone under the facts of the present case.

The underlying purpose of the reorganization provisions clearly requires that respondent's claim of exemption be rejected. While those provisions were meant to facilitate the readjustment of corporate structure by easing the tax burden, they were plainly intended at most to postpone the incidence of the tax. Thus, recognition of the gain on receipt of securities is deferred until their ultimate disposition. There was no intention whatever to grant a permanent exemption. See H. Rep. No. 179, 68th Cong., 1st Sess., pp. 16–17; S. Rep. No. 398, 68th Cong., 1st Sess., pp. 18–19.[7] In the case of money received by the corporation as part of the original exchange, the gain is taxable immediately to that extent, either to the corporation or, if the cash is distributed to the stockholders pur-

[7] These reports were made with respect to the bill that became the Revenue Act of 1924, which contained for the first time the provisions of law involved herein.

suant to the plan, then to the stockholders. H. Rep. No. 179; *supra*, pp. 14–15; S. Rep. No. 398, *supra*, pp. 18–19. Where the corporation employs the money to pay its debts, or directs in advance that it be applied to the payment of such debts, the income would *pro tanto* escape taxation altogether if the exemption granted by the reorganization provisions were to be held applicable. Accordingly, the basic philosophy underlying the reorganization provisions confirms and fortifies the result which the recent decision in the *Minnesota Tea Co.* case compels here.[8]

B

The District Court, after extended discussion, concluded (R. 175–177) that the assumption and discharge of Hendler's bonded indebtedness was not "other property or money" within the meaning of subsection (d). The Circuit Court of Appeals,

[8] The District Court asserted that the Government's position herein is "contrary to the administrative practice for more than ten years" (R. 175), and the Circuit Court of Appeals made a somewhat similar statement about the "usual practice of the Commissioner" (R. 203). Those assertions are wholly unsupported by any published rulings, either official or unofficial. Moreover, even published rulings, where not officially approved by the Secretary of the Treasury, are of little aid in construing the statute, and certainly cannot be deemed to have been brought to the attention of Congress so as to enjoy the presumption of legislative approval upon the reenactment of the Act. See *Helvering* v. *N. Y. Trust Co.*, 292 U. S. 455, 467–468; *Biddle* v. *Commissioner*, No. 55, present Term, decided January 10, 1938.

while not specifically so stating, likewise seemed to treat this item as not being "other property or money". (R. 204.)

We may assume, *arguendo,* that both the lower courts were correct in excluding this item of income from the phrase "other property or money".[9] The error of both courts is the conclusion that therefore subsection (d) grants an exemption. We contend that exactly the opposite result flows from subsection (d).

In order to bring into play the exemption contained in subsection (d), two things are necessary. First, there must be a receipt (in addition to stock or securities) of "other property or money"; and second, such "other property or money" must be "distributed" in pursuance of the plan of reorganization. These conditions are in the conjunctive,

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[9] While we accept that result for the purpose of argument, its correctness seems open to serious question. Subsection (b) (4) deals with exchanges "solely" for stock or securities. Subsection (d) deals with exchanges that are not solely for stock or securities; it undertakes to deal with exchanges that would be within subsection (b) (4) were it not for the fact that the property received in the exchange consists not merely of stock or securities but also of "other property or money". It would seem from the broad sweep of this language that Congress intended subsections (b) (4) and (d) to exhaust the totality of transfers in which stock or securities are received either as the sole or as part consideration for the exchange, and that therefore the phrase "other property or money" was meant to embrace all the consideration for the exchange other than stock or securities.

and the exemption sought under subsection (d) must be denied if either of them is not complied with. And we have endeavored to show, *supra*, pp. 11–13, that there was not a "distribution" within the meaning of subsection (d). That alone is sufficient to defeat the exemption.

But, if this item of income is not "other property or money", the claim for exemption must fail on that account, as well. For, subsection (d) is applicable only to the extent that it involves "other property or money". If this item of income is not "other property or money", then subsection (d) has no operative effect whatever, and the exemption sought thereunder must of necessity be denied. In short, if the assumption and discharge of Hendler's bonded indebtedness does not constitute the receipt of "other property or money" within the meaning of subsection (d), then *first*, the exemption granted by subsection (d) can have no application here, and *second*, the case is reduced to the situation that would exist if Section 112 were entirely absent from the statute. That situation calls merely for the determination of whether this item is taxable income under Sections 13, 21, and 22; and as we have pointed out, *supra*, pp. 8–9, it plainly is taxable income to Hendler whether denominated "constructive receipt" or described by any other label.

CONCLUSION

The judgment of the Circuit Court of Appeals should be reversed.

Respectfully submitted.

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FEBRUARY, 1938.

APPENDIX

Revenue Act of 1928, c. 852, 45 Stat. 791:

SEC. 13. TAX ON CORPORATIONS.

(a) *Rate of tax.*—There shall be levied, collected, and paid for each taxable year upon the net income of every corporation, a tax of 12 per centum of the amount of the net income in excess of the credits against net income provided in section 26.

* * * * *

SEC. 21. NET INCOME.

"Net income" means the gross income computed under section 22, less the deductions allowed by section 23.

SEC. 22. GROSS INCOME.

(a) *General definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever.

* * * * *

SEC. 112. RECOGNITION OF GAIN OR LOSS.

(a) *General rule.*—Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.

(b) *Exchanges solely in kind.*—

* * * * *

(4) SAME [STOCK FOR STOCK ON REORGANIZATION]—GAIN OF CORPORATION.—No gain or loss shall be recognized if a corporation a party to a reorganization exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation a party to the reorganization.

* * * * *

(d) *Same [Gain from exchanges not solely in kind]—gain of corporation.*—If an exchange would be within the provisions of subsection (b) (4) of this section if it were not for the fact that the property received in exchange consists not only of stock or securities permitted by such paragraph to be received without the recognition of gain, but also of other property or money, then—

(1) If the corporation receiving such other property or money distributes it in pursuance of the plan of reorganization, no gain to the corporation shall be recognized from the exchange, but

(2) If the corporation receiving such other property or money does not distribute it in pursuance of the plan of reorganization, the gain, if any, to the corporation shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property so received, which is not so distributed.

* * * * *

(i) *Definition of reorganization.*—As used in this section and sections 113 and 115—

(1) The term "reorganization" means (A) a merger or consolidation (including the acquisition by one corporation of at least

a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or substantially all the properties of another corporation), or (B) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred, or (C) a recapitalization, or (D) a mere change in identity, form, or place of organization, however effected.

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